C.D. Howe Institute
Institut C.D. Howe

Backgrounder

February 27, 1991

A Partial Cure: The 1991 Federal Budget

by

Irene K. Ip and William B.P. Robson

The conservative nature of the Budget's economic assumptions is encouraging. The fiscal projections do not depend on unrealistically robust short-term economic growth or on implausibly large longer-term interest rate declines. Pleasant surprises are possible, particularly on the interest rate front.

The presentation of inflation targets is a key initiative — although with significant risks. There are two reasons for commending this step. It enhances the government's accountability with respect to a central objective of economic policy: price stability, and it may aid the disinflationary process by lowering inflationary expectations. Risks arise, however, in the possible interpretation of these targets. In particular, given the very slow progress toward price stability projected after 1992, and the numerous qualifications placed on the objective, there is a possibility that the targets may prove to be a floor rather than a ceiling.

In our view, the near-term targets — core CPI inflation around 4% by year-end 1991 and 3% by year-end 1992 — are virtually assured, given the Bank's recent stance. The momentum of the disinflationary process, reinforced by the continued high real short-term interest rates in the budget forecast, suggests that price stability (CPI inflation averaging under 2% annually) can be achieved much sooner than the second half of the decade. These targets thus imply that the battle against inflation may be aborted before its goal is achieved.

On the fiscal front, the projections for 1991/92 show a real commitment to hold the deficit down under adverse conditions. But this effort is followed by disappointing reductions in 1992/93 and beyond. The fiscal plan depends heavily on an assumption of surprisingly strong non-UI revenue growth and near-term discretionary tax increases, while the government has made a very incomplete effort to re-order its spending priorities according to clearly stated goals.

Rather than take this route, the budget extends last year's restraints on a broad range of programs. Similarly, although the wage cap on the civil service builds in flexibility, it sidesteps the need for eliminating superfluous civil service positions. Moreover, the impact on the total budget of this sort of program is limited, and it imposes a cost in terms of civil service efficiency and morale. Cuts in transfers to the provinces, though justified in the sense that the federal deficit is a national problem, cannot be divorced from the question of responsibility for the design of shared-cost programs. If the federal government withdraws its cash transfers for health care, for example, how can it justify its promised reinforcement of national standards in medicare?

Yet despite these cuts (and allowing for the impact of a weaker economy on transfer payments) spending restraint has been inade-

CDH
LIB
ARCH

103-00957/

quate. For instance, obscured by a dramatic reduction in spending reserves is a $3.6 billion increase in "other transfers", few details of which are explained. Instead, tax increases — particularly a hike in UI premiums inappropriate at this stage in the business cycle — carry the bulk of the load in 1991/92, while the inadequate spending restraint in 1992/93 looks like a pre-election splurge.

The budget also contains unusual proposals with uncertain medium-term implications. The proposed legislated limits on total program spending offer a potential discipline on spendthrift cabinet ministers, removing pressure for tax or debt increases. The exclusion of self-funding accounts from these limits opens the door to a key innovation in budget policy advocated by the Institute: the separation of the UI Account from the main budget, and the concentration of the stabilizing power of the federal budget in it. (This would be in sharp contrast to the erosion of the UI Account's stabilization properties by this Budget.) Given the sensitivity of nominal dollar figures to changes in inflation, however, this sort of targeting would be more meaningful if the limits were specified in real (that is, constant dollar) terms.

The decision to establish a Debt Servicing and Reduction Fund, with GST revenues dedicated to it, hardly merits the characterization "fundamental structural reform". From an economic perspective, the link between the GST and interest costs is obscure, to say the least. This innovation may be intended to make a hike in the GST rate to deal with a fiscal setback easier to sell politically. Over the long haul, however, this move raises a number of questions. For example, would continued segregation of GST revenue at a time when the fiscal burden of interest costs has shrunk bias future finance ministers in favor of other sources to finance program expenditures?

Erratum

C.D. Howe Institute Commentary 27, *Strong Medicine: Budgeting for Recession and Recovery*, referred (p. 16) to a ratio of "administration" to transfer expenditures by the Department of Veterans Affairs of 1:3. Veterans Affairs has informed us that this ratio is not correct, because its non-transfer budget includes operation of a hospital and two old-age homes, as well as administration.

The government's effort to hold the 1991/92 deficit to $30.5 billion is commendable, tainted though it is by a very ill-timed increase in UI premiums. The favorable impact of several factors on the 1992/93 deficit, however, has weakened the government's resolve to continue with vigorous restraint. Instead of an ambitious — but achievable — target of around $20 billion, the budget aims only for $24 billion. The deficit is projected to fall to a level consistent with a prudent fiscal plan ($6.5 billion) by 1995/96, but the pace of reduction is too leisurely, and is only achieved with revenues far higher, in relation to GDP, than was forecast in the 1990 Budget — and higher than we feel is justified.

There is, however, one major window of opportunity for improving the medium-term fiscal plan. The ongoing federal-provincial discussions over equalization payments, and the expected negotiations over tax and transfer issues, in the context of a comprehensive national reform, may allow progress on the deficit beyond that indicated in this budget. It is essential for both levels of government to continue to build on the tentative progress toward fiscal balance made at the end of the 1980s, in order to arrest the cumulative erosion of Canada's future prospects represented by the relentless growth of the public debt.

Backgrounder © is an occasional publication of the C.D. Howe Institute. Its purpose is to comment briefly on policy issues of immediate concern to Canadians.

As with all Institute publications, the views expressed here are those of the authors and do not necessarily reflect the opinions of the Institute's members or Board of Directors.

Irene Ip and William Robson, the authors of this issue of *Backgrounder*, are Senior Policy Analysts at the C.D. Howe Institute.

Copies of *Backgrounder* are available from the Institute at no charge. For further information, please contact: Barry A. Norris, Director of Publications, C.D. Howe Institute, 125 Adelaide Street East, Toronto, Ontario M5C 1L7 (tel.: 416-865-1904; fax: 416-865-1866).

Quotation with appropriate credit is permissible.